

**COMMONWEALTH OF MASSACHUSETTS
OFFICE OF THE SECRETARY OF THE COMMONWEALTH
SECURITIES DIVISION
ONE ASHBURTON PLACE, ROOM 1701
BOSTON, MASSACHUSETTS 02108**

IN THE MATTER OF:)

MORGAN STANLEY SMITH BARNEY LLC)

) Docket No. E-2016-0041
)

CONSENT ORDER

I. PRELIMINARY STATEMENT

This Consent Order (the “Order”) is entered into by the Massachusetts Securities Division (the “Division”) and Morgan Stanley Smith Barney LLC (“Morgan Stanley”) with respect to the investigation by the Enforcement Section of the Massachusetts Securities Division (the “Enforcement Section”) into whether Morgan Stanley’s activities and conduct violated the Massachusetts Uniform Securities Act, MASS. GEN. LAWS ch. 110A (“Act”), and the corresponding regulations promulgated thereunder at 950 MASS. CODE REGS. 10.00 – 14.413 (“Regulations”).

On October 29, 2019, Morgan Stanley submitted an Offer of Settlement (the “Offer”) to the Division. Solely for the purpose of settlement, Morgan Stanley neither admits nor denies the Statement of Facts set forth in Section VI and the Violations of Law set forth in Section VII below, and consents to the entry of this Order by the Division, consistent with the Offer, settling the investigation (E-2016-0041) hereby with prejudice.

II. JURISDICTION

1. As provided for by the Act, the Division has jurisdiction over matters relating to securities pursuant to chapter 110A of Massachusetts General Laws.
2. The Offer was made and this Order is entered in accordance with the Act. Specifically, the acts and practices investigated took place in Massachusetts.

III. RELEVANT TIME PERIOD

3. Except as otherwise expressly stated, the conduct described herein occurred during the period of January 1, 2010 to May 1, 2014 ("Relevant Time Period").

IV. RESPONDENT

4. Morgan Stanley Smith Barney LLC ("Morgan Stanley") is a broker-dealer and investment adviser with headquarters in Purchase, New York. Morgan Stanley has a Financial Industry Regulatory Authority ("FINRA") Central Registration Depository ("CRD") number of 149777. Morgan Stanley has been registered as a broker-dealer in Massachusetts since May 22, 2009.

V. RELATED INDIVIDUAL

5. Justin E. Amaral ("Amaral") is a natural person with a last known address in Boston, Massachusetts. Amaral has a FINRA CRD number of 4440980. Amaral was registered as a broker-dealer agent in Massachusetts from August 15, 2001 to May 7, 2014.

VI. STATEMENT OF FACTS

A. Morgan Stanley and Justin Amaral

6. During the Relevant Time Period, Morgan Stanley had a number of stand-alone branches and complexes in the Boston area.

7. From 2007 to 2009, Amaral worked as a financial advisor ("FA") in the Smith Barney unit of Citigroup Global Markets, Inc. ("CGMI"). He was based out of the 53 State Street/Boston Harbor branch.
8. In 2009, CGMI contributed its Smith Barney unit to a joint venture with Morgan Stanley. Following this joint venture, Amaral worked as an FA for Morgan Stanley from 2009 to 2014.
9. While employed at Morgan Stanley, Amaral was the broker of record for at least 455 client accounts whose owners had a primary address in Massachusetts ("Massachusetts Clients").
10. During the Relevant Time Period, Amaral had two immediate supervisors and two relevant indirect supervisors.
11. Between June 2012 and February 2014, Amaral was directly supervised by a Complex Manager ("Direct Supervisor One").
12. Between February 2014 and May 2014, Amaral was directly supervised by a second Complex Manager ("Direct Supervisor Two").
13. Between June 2012 and August 2013 and between December 2013 and May 2014, Amaral was indirectly supervised by a Senior Complex Risk Officer ("Indirect Supervisor One").
14. Between July 2013 and May 2014, Amaral was indirectly supervised by a second Complex Risk Officer ("Indirect Supervisor Two"). Indirect Supervisor Two's territory included the 53 State Street/Boston Harbor branch located in Boston, Massachusetts. Indirect Supervisor Two had been employed with Morgan Stanley for twenty years.

15. On May 1, 2014, Amaral resigned from Morgan Stanley during Morgan Stanley's internal investigation of Amaral's conduct.

B. Amaral Churned Certain Massachusetts Client Accounts

16. During the Relevant Time Period, Morgan Stanley's Written Supervisory Procedures ("WSPs") explicitly prohibited churning.

17. According to Section 8.12.2 of Morgan Stanley's WSPs:

Churning occurs when an FA/PWA, for the purpose of generating commissions recommends or effects transactions that are excessive in size or frequency in light of a client's stated financial resources, investment objectives, and investment history.

18. In order for churning to occur, the excessive trading activity must be contrary to the client's investment objectives. Furthermore, the broker must have either actual or *de facto* control over a customer's account. Lastly, the broker-dealer agent must have intended to defraud the customer.

19. Turnover ratios and cost-to-equity ratios have historically been used as a quantitative measure of churning.

20. The turnover ratio measures the rate at which securities in an account were traded within a certain time period.¹

21. The cost-to-equity ratio measures the rate of return that an account would need to generate to make up for the costs of commissions, fees, and margin interest charged to the account.²

¹ The turnover ratio is calculated by dividing the total cost of purchases made during a given period by the average equity in the account during the relevant period.

² The cost-to-equity ratio is calculated by dividing the total amount of commissions, markups, markdowns, costs and margin interest by the average equity in the account during the relevant period.

22. During the Relevant Period, Morgan Stanley used turnover ratios and cost-to-equity ratios to generate exception reports to help identify possible instances of churning, among other things.

23. A review of client account statements and trade blotter information for Massachusetts investors demonstrates that Amaral repeatedly churned certain client accounts during the Relevant Time Period.

24. Amaral was able to buy and sell large volumes of securities by exercising *de facto* control over these clients' accounts.

C. Amaral Churned Customer Accounts in Violation of Morgan Stanley's Supervisory Procedures

25. During the Relevant Time Period, Morgan Stanley's supervisory personnel were responsible for ensuring compliance with Morgan Stanley's internal policies and procedures.

26. Supervisory personnel were required to approve new accounts; maintain client accounts; review trade activity; supervise mutual fund transactions; and handle client complaints and other legal and regulatory matters for the branch.

27. During the Relevant Time Period, Morgan Stanley's policies and procedures specifically addressed excessive trading.

28. Nevertheless, Morgan Stanley's supervisory personnel failed to prevent Amaral from churning certain customer's accounts.

i. Morgan Stanley's Supervisors Failed to Prevent Amaral From Churning Customer Accounts

29. Amaral's supervisors failed to follow up adequately after receiving numerous alerts generated from Amaral's client accounts in connection with excessive trading.

30. During the Relevant Time Period, Morgan Stanley's WSPs required Branch Managers or their delegates to review the daily trading activity in the accounts maintained in their branch for compliance with Morgan Stanley's policies and procedures.

31. Section 8.12.2 of the WSPs instructed supervisory personnel to speak directly with the relevant financial advisor if the supervisor identified an account with a high number of trades or a high turnover ratio in relation to the account information provided by the client. Supervisory personnel were supposed to discuss the account with the FA/PWA to determine the suitability of the trading strategy for the account.

32. Section 8.12.2 recommended that supervisory personnel consider each of the following factors in order to determine whether or not a high number of trading activity indicated excessive trading activity:

- whether the account is a commission-based or fee-based account;
- whether any reasonable objective exists for the account activity other than to generate commissions;
- whether the activity is in line with the client's stated investment objectives, level of sophistication, and financial situation;
- whether the trades were solicited; and
- the relationship between the FA/PWA and the client and the frequency of communications between the FA/PWA and the client.

33. Morgan Stanley used an automated system of "Action Review Alerts" to monitor financial advisor's trading activity.

34. The "Action Review Alerts" included a Cost-to-Equity Ratio alert and a Turnover alert.

35. For each "Action Review Alert," a supervisor was required to respond to an alert within one month of it being generated. Specifically, supervisors were required to either take a follow-up action or indicate that no further action was necessary.

36. The WSPs instructed supervisory personnel to consider the following factors when reviewing Action Review Alerts:

- whether the activity in the account is solicited;
- the ratio of account commissions to the FA/PWA's gross production;
- whether the activity in the account is consistent with the client's stated investment objectives, financial situation, and age;
- whether the account, or the FA . . . on the account, repeatedly appears on the current Account Review or on the Prior Alerts tab;
- whether the account has large losses;
- whether the turnover and cost-to-equity ratios in the client's account are consistent with the client's stated investment objectives; and whether there are any patterns of trading between unrelated clients.

37. In instances where the cost-to-equity ratio had a one, three, or twelve-month ratio of 5.5% or greater, the WSPs required supervisory personnel to either contact the client or indicate in writing why they did not feel client contact was necessary.

38. Throughout the Relevant Time Period, numerous alerts were generated in Amaral's client accounts.

39. Amaral received at least 97 alerts during the Relevant Time Period.

40. Several of the alerts for certain of the Massachusetts Clients indicated a high turnover ratio and/or cost-to-equity ratio.

41. Morgan Stanley's records indicate that Amaral's supervisors typically reached out directly to Amaral in order to determine the reasoning behind the alerts, as well as his clients to ensure they were aware of their account performance.

42. Comments and e-mails suggest that most of these alerts were closed out after speaking with Amaral and determining that the excessive trading resulted from poor performance in the market or account rebalancing.

43. For instance, on August 20, 2013, Indirect Supervisor One closed out an alert indicating a high cost-to-equity ratio in the account of one of the Massachusetts Clients (Investor Four). In her comment, she stated that:

FA recommended client purchase firm's ETF's, which performed poorly and were sold to limit additional losses. FA repositioned portfolio with diversified ETF's and does not anticipate implementing changes near term.

44. Indirect Supervisor One's comment was made after three similar alerts had been generated in the account.

D. Morgan Stanley Failed to Adequately Supervise Amaral

45. The Division maintains that the closure of activity review alerts and accompanying comments suggest that Morgan Stanley's supervisors failed to adequately monitor Amaral's trading activity in a manner that was consistent with the firm's policies and procedures.

46. Morgan Stanley's Legal and Compliance Department initiated a formal investigation of Amaral in 2014 following a customer complaint.

47. In or around September 2013, a Morgan Stanley Complex Risk Officer received an alert indicating overconcentration in this client's accounts. In response, the Complex Risk Officer contacted the client to discuss the trading activity in her account. At that time, the client said that she was aware of the concentrated position in her account and did not wish to alter her trading strategy at that time. The Complex Risk Officer sent the client a letter confirming their conversation and continued to monitor Amaral's clients' accounts.

48. In April of 2014, Morgan Stanley was contacted by the client's accountant regarding the excessive trading activity in the client's account and Amaral's designation

as the executor of the client's estate and as a beneficiary of the client's will. Amaral had failed to disclose this fiduciary relationship to Morgan Stanley, in violation of its written supervisory procedures.

49. The complaint prompted the Complex Risk Officer to escalate the matter to Morgan Stanley's Legal and Compliance Department, which initiated an investigation.

50. According to the Form U5 filed by Morgan Stanley, the firm initiated its internal review on April 15, 2014. The review concluded on May 1, 2014, when Amaral resigned at the start of an investigative interview.

51. After reviewing Amaral's book of business, Morgan Stanley focused its investigation on certain of Amaral's clients and the general sales practice concerns that had been raised in the prior client complaint.

52. As part of the investigation, the Complex Risk Officer reached out to these selected clients to discuss their trading activity and relationships with Amaral.

53. The investigation revealed that numerous issues related to trading activity in the accounts of the selected customers. Several of these clients filed complaints against Amaral alleging excessive trading. Morgan Stanley investigated these complaints, which were resolved on a case-by-case basis.

VII. VIOLATIONS OF LAW

Count I – Violations of MASS. GEN. LAWS ch. 110A § 204(a)(2)(J)

54. Section 204 of the Act provides:

The secretary may by order impose an administrative fine or censure or deny, suspend, or revoke any registration or take any other appropriate action if he finds (1) that the order is in the public interest and (2) that the applicant or registrant [...]:

(J) has failed reasonably to supervise agents, investment advisers representatives or other employees to assure compliance with this chapter
[.]

MASS. GEN. LAWS ch. 110A, § 204(a)(2)(J).

55. The conduct of Morgan Stanley, as described above, constitutes violations of
MASS. GEN. LAWS ch. 110A, § 204(a)(2)(J).

VIII. ORDER

IT IS HEREBY ORDERED:

- A. Morgan Stanley shall permanently cease and desist from further conduct in violation of MASS. GEN. LAWS ch. 110A § 204(a)(2)(J);
- B. Morgan Stanley is censured by the Division;
- C. Morgan Stanley shall provide restitution to Investor One, Investor Two, Investor Three, and Investor Four, as identified by the Enforcement Section, (collectively, the "Massachusetts Investors") in the amount of \$182,500, subject to the following terms:
 - 1. Within fifteen (15) days of the Order, Morgan Stanley shall provide the Enforcement Section with an accounting of those losses attributable to the alleged wrongdoing, including, but not limited to, commissions and investor losses in the accounts of the Massachusetts Investors;
 - 2. Morgan Stanley shall make written offers of restitution to the Massachusetts Investors. Within thirty (30) days of the Order, Morgan Stanley shall submit a draft of the proposed written offers of restitution to the Enforcement Section prior to making any written offers of restitution. The proposed written offers shall not be unacceptable to the Enforcement Section;

3. The written offers of restitution shall remain open to the Massachusetts Investors for at least ninety (90) days (the "Offer Period");
4. Within fifteen (15) days following the expiration of the Offer Period, Morgan Stanley shall make payment to the Massachusetts Investors who accepted written offers of restitution; and
5. Within thirty (30) days following the date that Morgan Stanley makes restitution payments, Morgan Stanley shall provide the Enforcement Section with a final accounting (the "Final Accounting") and certification of the disposition of the restitution payments. The Final Accounting shall be in a form not unacceptable to the Enforcement Section and include: (1) the name and address of each recipient of restitution; (2) the amount paid to each individual that accepted the offer of restitution; (3) the date of each payment; (4) evidence of all payments made; (5) the date and amount of any returned payment(s); (6) a description of any effort to locate a prospective recipient of an offer of restitution whose payment was returned, or to whom payment was not made due to factors beyond Morgan Stanley's control; and (7) the balance of any undistributed funds, if any. Morgan Stanley shall cooperate with requests for information in connection with the Final Accounting and provide supporting documentation to the Enforcement Section upon request.

D. Morgan Stanley shall provide, within sixty (60) days of the Order, a report to the Division detailing the changes and enhancements made to Morgan Stanley's policies and

procedures governing the conduct at issue in this Offer. The report will include, at a minimum, a description of the changes made;

E. Morgan Stanley shall, within fifteen (15) business days of the Order, pay an administrative fine in the amount of \$200,000 (USD) to the Commonwealth of Massachusetts. Payment shall be: (1) made by United States postal money order, certified check, bank cashier's check, bank money order, or wire transfer; (2) made payable to the Commonwealth of Massachusetts; (3) either hand-delivered or mailed to One Ashburton Place, Room 1701, Boston, Massachusetts 02108, or wired per Division instructions; and (4) submitted under cover letter or other documentation that identifies the payor making the payment and the docket number of the proceedings. Additionally, Morgan Stanley shall provide the Enforcement Section with notice twenty-four (24) hours prior to the payment;

F. Morgan Stanley shall not claim, assert, or apply for a tax deduction or tax credit with regard to any state, federal or local tax for any amounts that Morgan Stanley shall pay pursuant to the Order;

G. Morgan Stanley shall not seek or accept, directly or indirectly, reimbursement or indemnification, including, but not limited to, any payments made pursuant to any insurance policy, with regard to any amount that Morgan Stanley shall pay pursuant to the Order;

H. Upon the issuance of the Order, if Morgan Stanley fails to comply with any of the terms set forth in the Order, the Enforcement Section may institute an action to have this agreement declared null and void. Upon issuance of an appropriate order and after a fair

hearing, the Enforcement Section may re-institute the administrative proceeding and associated investigation that had been brought against Morgan Stanley; and

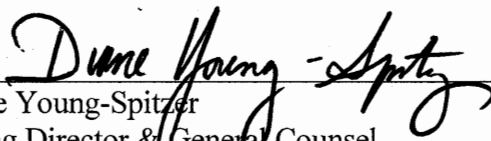
I. For good cause shown, the Division may extend any of the procedural dates set forth above. Morgan Stanley shall make any requests for extensions of procedural dates set forth above in writing to the Division.

IX. NO DISQUALIFICATION

This Order waives any disqualification in the Massachusetts laws, or rules or regulations thereunder, including any disqualification from relying upon the registration exemptions or safe harbor provisions to which Morgan Stanley may be subject. A signed Order entered pursuant to this Offer is not intended to be a final order based upon violations of the Act that prohibit fraudulent, manipulative, or deceptive conduct. A signed Order issued pursuant to this Offer is not intended to form the basis of any disqualifications under Section 3(a)(39) of the Securities Exchange Act of 1934; or Rules 504(b)(3) and 506(d)(1) of Regulation D, Rule 262(a) of Regulation A and Rule 503(a) of Regulation CF under the Securities Act of 1933. A signed Order issued pursuant to this Offer is not intended to form the basis of disqualification under the FINRA rules prohibiting continuance in membership absent the filing of a MC-400A application or disqualification under SRO rules prohibiting continuance in membership. This Order is not intended to form a basis of a disqualification under 204(a)(2) of the Uniform Securities Act of 1956 or Section 412(d) of the Uniform Securities Act of 2002. Except in an action by the Division to enforce the obligations of this Order, any acts performed or documents executed in furtherance of this Order: (a) may not be deemed or used as an admission of, or evidence of, the validity of any alleged wrongdoing, liability, or lack of any wrongdoing or liability; or (b) may not be deemed or used as an admission of, or

evidence of, any such alleged fault or omission of Morgan Stanley in any civil, criminal, arbitration, or administrative proceeding in any court, administrative agency, or tribunal.

WILLIAM FRANCIS GALVIN
SECRETARY OF THE COMMONWEALTH

By: 
Diane Young-Spitzer
Acting Director & General Counsel
Massachusetts Securities Division
One Ashburton Place, Room 1701
Boston, MA 02108

Date: October 29, 2019